

OFFICE OF
THE CITY ATTORNEY
CITY OF SAN DIEGO
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MEMORANDUM OF LAW

DATE: September 25, 2018
TO: Gail Granewich, City Treasurer
FROM: City Attorney
SUBJECT: Cannabis Business Tax Collection

INTRODUCTION

On November 8, 2016, California voters approved Proposition 64 legalizing adult use, cultivation, and retail sale of recreational cannabis in California. Voters also approved City of San Diego Measure N, establishing a Cannabis Business Tax in the San Diego Municipal Code (Municipal Code or SDMC). The Cannabis Business Tax applies to both cannabis sales and sales of “ancillary products.”

On January 1, 2018, local marijuana outlets began to sell recreational cannabis along with medicinal cannabis.¹ As the tax administrator for the City of San Diego (City), your office has begun collecting Cannabis Business Tax from cannabis business operators, and has requested guidance on the taxability of certain transactions, including ancillary product sales, transactions that cross City limits, and medicinal cannabis sales. This memorandum responds to your questions.

QUESTIONS

1. Are cannabis-related products taxable “ancillary products” when sold by a business that does not manufacture, sell, or distribute cannabis (i.e., non-cannabis businesses)?
2. How does the tax apply to transactions that cross City limits?
3. When are medical cannabis transactions excluded from the tax?

¹ The terms “marijuana” and “cannabis” are synonymous. Most references to “marijuana” have been replaced with “cannabis” in California state statutes and regulations, but the Municipal Code still uses “marijuana” in its permitting and land-use provisions. *See* Sen. Bill 94 (2017-2018 Reg. Sess.); SDMC §§ 42.1501- 42.1510, 141.0504, and 141.1004. In this memorandum, “marijuana” and “cannabis” are both used based on the relevant statutory text.

SHORT ANSWERS

1. No. Cannabis-related products are not taxable “ancillary products” unless sold by businesses that manufacture, sell, or distribute cannabis (i.e. cannabis businesses).
2. The Cannabis Business Tax applies only to gross receipts from cannabis business occurring within City limits. The Treasurer’s Office may issue guidelines to assist operators in apportioning transactions that cross City limits.
3. Measure N excludes only medical cannabis sales by nonprofits, but the City can amend the Municipal Code to apply the exclusion to medical sales by for-profit businesses. The City Treasurer may also be able to issue guidelines to exclude transactions if reasonably necessary to collect the tax as voters intended.

BACKGROUND

State and local cannabis regulation and taxation in California have evolved significantly in the years since voters first approved the Compassionate Use Act in 1996. Prop. 215, Gen. Elec. (Nov. 5, 1996); Cal. Health & Safety Code § 11362.5. In 2003, the Medical Marijuana Program Act (MMP) gave qualified medical marijuana patients and their primary caregivers² immunity from state criminal prosecution and authorized nonprofit cooperatives and collectives to distribute marijuana among their members.³ Sen. Bill 420 (2003-2004 Reg. Sess.). The MMP also authorized the Medical Marijuana Identification Card (MMIC) Program to assist retailers and law enforcement in identifying and verifying medical marijuana patients and caregivers. *Id.*

In November 2016, voters approved Proposition 64, the Control, Regulate and Tax Adult Use of Marijuana Act, legalizing recreational marijuana for adult-use under California state law. Prop. 64, Gen. Elec. (Nov. 8, 2016). Proposition 64 approved state excise taxes on all marijuana sales, but exempted medical marijuana transactions with MMIC cardholders from sales and use tax. Voters also approved Measure N to establish a City tax of up to 15% on “non-medical cannabis (also known as marijuana) businesses operating in the City.” Measure N, Gen. Elec. (Nov. 8, 2016); SDMC §§ 34.0101-34.0132.

² A “qualified patient” is a person whose physician has recommended marijuana to treat an illness for which marijuana provides relief. Cal. Health & Safety Code § 11362.5(b)(1)(A). A “primary caregiver” is a person who is designated by a qualified patient to consistently grow and supply medical marijuana as needed. *Id.* § 11362.5(e).

³ Medical marijuana distributors could operate under two nonprofit models:

- (1) Statutory cooperatives, which are nonprofit mutual benefit corporations. Cal. Corp. Code § 12201. They are strictly prohibited from making a profit from the marijuana sales and must use all earnings for members’ general welfare or equitably distribute to members as cash, property, credits or service.
- (2) Collectives, which are not defined by statute, but are nonprofit organizations that facilitate patient and caregiver members’ collaborative efforts.

California Attorney General Guidelines for the Security and Non-Diversion of Marijuana Grown for Medical Use, California Department of Justice, at 8 (August 2008), https://medicalmarijuana.procon.org/sourcefiles/Brown_Guidelines_Aug08.pdf (A.G. Guidelines).

ANALYSIS

I. ALL PRODUCTS SOLD BY A CANNABIS BUSINESS ARE TAXABLE.

You asked if cannabis-related products, like pipes used to smoke cannabis or fertilizer used to grow cannabis, are taxable “ancillary products” when sold by non-cannabis businesses that do not sell actual cannabis. Measure N discusses “ancillary products” it says:

“*Cannabis Business*” means any activity which entails the distribution, delivery, dispensing, exchanging, bartering or sale of non-medical *Cannabis*, including but not limited to, transporting, manufacturing, cultivating, compounding, converting, processing, preparing, storing, packaging, wholesale, or retail sales of *Cannabis* and any **ancillary products** in the City, whether or not carried on for gain or profit.

Id.; SDMC § 34.0103(b) (bolded emphasis added.)

When interpreting voter initiatives, the primary aim is to determine and effectuate the voters’ intent. *Bighorn-Desert View Water Agency v. Verjil*, 39 Cal. 4th 205, 212 (2006). Courts first look at a measure’s plain language, using ordinary, dictionary meanings. *Id.* When clear and unambiguous, courts assume that voters intended for the plain language to control. *Prof’l Eng’rs in Cal. Gov’t v. Kempton*, 40 Cal. 4th 1016, 1037 (2007). “Ancillary” means “supplementary.” *Black’s Law Dictionary* 105 (10th ed. 2014).

Thus, the relevant inquiry for determining whether an item is a taxable “ancillary product” is whether the operator’s business entails “transporting, manufacturing, cultivating, compounding, converting, processing, preparing, storing, packaging, wholesale, or retail sales of cannabis.” For example, if a retailer sells cannabis and T-shirts, gross receipts from both are taxable. If a business sells pipes, but not cannabis, the business is exempt from the tax, even if its products are used to consume cannabis.

II. OPERATORS ARE LIABLE FOR TAXES ON ALL CANNABIS BUSINESS ACTIVITIES OCCURRING WITHIN CITY LIMITS UNLESS AN EXCEPTION APPLIES.

California cities can tax the gross receipts from certain business activities occurring within city limits, but those taxes cannot place an undue burden on intercity business. *City of Los Angeles v. Shell Oil Co.*, 4 Cal. 3d 108, 119 (1971). California courts have found that local gross receipts taxes comply with equal protection and due process constitutional requirements when limited to activities occurring within the locality. *City of Modesto v. National Med, Inc.*, 128 Cal. App. 4th 518 (2005). Accordingly, gross receipts subject to the Cannabis Business Tax include only the portion attributable to activities occurring in the City. SDMC § 34.0103(f).

By way of illustration, if an operator manufactures cannabis products within City limits and then sells those products to a business in a different jurisdiction, at least some sales activity

will occur in San Diego, *e.g.*, the person taking the order over the phone or computer or preparing the product for shipment would be doing so within City limits. Only the portion of gross receipts attributable to the sales activity in San Diego is taxable. Conversely, for operators located outside City limits, sales to businesses within City limits will usually include some taxable activity in the City, *e.g.*, gross receipts attributable to delivery or collecting payment in San Diego.

There is no exact formula for apportioning gross receipts attributable to out-of-City activities, but the City Treasurer may issue guidelines to assist operators in apportioning gross receipts. *Id.* § 34.0122.⁴ In the absence of guidelines, however, operators bear the burden of proving that the method they use properly apportions the value of gross receipts excluded from the tax.⁵ *Shell Oil Co.*, 4 Cal. 3d at 126.

III. CURRENTLY, ONLY NONPROFIT OPERATORS MAY EXCLUDE MEDICAL CANNABIS TRANSACTIONS FROM TAXATION.

Approving Measure N at the same election as Proposition 64 allowed the City to collect taxes on recreational cannabis as soon as legal sales began on January 1, 2018. Measure N limited the tax to non-medical cannabis business by excluding: (1) nonprofit “medical marijuana consumer cooperatives” under the Municipal Code, and (2) nonprofit “[m]edical marijuana activities authorized under [California] Health and Safety Code section 11362.765. . . .” SDMC § 34.0103(b). These exclusions covered all City-permitted medical marijuana sales at the time. *See* San Diego Ordinances O-20042 and O-20043 (Apr. 27, 2011); Prop. 64, Gen. Elec. (Nov. 8, 2016). However, subsequent amendments to both state and local regulations raise the question of how to apply the medical marijuana exclusion to the current business model.

A. Changes to the Cannabis Regulatory Scheme After Voters Approved Measure N Have Led to Ambiguity in the Medical Marijuana Exclusion.

State and local legislation implementing Proposition 64 amended several significant regulatory provisions after the passage of Measure N. For example, the California Legislature eliminated a requirement that multiple licensees maintain separate and distinct premises. Assem. Bill 133 (2017-2018 Reg. Sess.); Cal. Bus. & Prof. Code § 26053. As a result, most of the City’s nonprofit medical marijuana consumer cooperatives have become for-profit marijuana outlets, selling both medical and recreational marijuana. These for-profit operations are neither medical marijuana consumer cooperatives nor authorized by California Health and Safety Code section 11362.765, the specific exclusions identified in Measure N.

⁴ Other jurisdictions have already issued guidelines for apportioning similar cannabis taxes, providing percentages based on the specific activity taking place in the jurisdiction. For example, in the City of Oakland, an out-of-city seller owes the local cannabis tax on up to 15% of the gross receipts for making a sale to an Oakland buyer, up to 30% if it delivers to Oakland, and up to an additional 5% if the payment is made in Oakland. *See* City of Oakland Office of Finance Revenue Division, Director of Finance Ruling No. 10 (Nov. 2, 2017), <http://www.oaklandnet.com/government/fwawebwrite/revenue/revenue-taxrulings.htm>.

⁵ If an operator believes any promulgated apportionment guidelines place an undue burden on interstate commerce or another constitutional burden, they can use the formula in the guideline, pay the tax, and then apply for additional apportionment. SDMC § 34.0123. An operator could also use an alternative method to apportion, but would bear the burden of proving its method properly apportioned the tax during an audit.

The changing nature of cannabis businesses has created confusion over whether Measure N exempts medical cannabis sales even when they are sold by a for-profit business. In 2017, the City replaced medical marijuana consumer cooperatives with marijuana outlets allowed to sell both recreational and medical marijuana, and added production activities. San Diego Ordinances O-20793 and O-20795 (Feb. 22, 2017); San Diego Ordinances O-20858 and O-20859 (Oct. 17, 2017); SDMC §§ 42.1501-42.1510, 141.0504, and 141.1004. Many of these for-profit operators have been excluding medical marijuana transactions from gross receipts subject to the tax on the stated belief that Measure N was intended to exclude all medical cannabis transactions, not just medical cannabis sales by nonprofit businesses.

The legislative materials supplementing Measure N provide insight into voter intent. Measure N was named the “Non-Medical Cannabis Business Tax” and its stated purpose and intent was to impose a “tax on non-medical marijuana cannabis businesses.” Measure N, Gen. Elec. (Nov. 8, 2016); SDMC § 34.0101. The City Attorney’s Impartial Analysis: stated “[M]edical marijuana consumer cooperatives licensed by the City would be exempt from the [C]annabis [B]usiness [T]ax, as would certain transactions involving patients and primary caregivers under the Compassionate Use Act.” Ballot Pamp., Gen. Elec. (Nov. 8, 2016), City Attorney’s Impartial Analysis.

These materials suggest that the voters intended to exclude only nonprofit medical marijuana consumer cooperatives and specific nonprofit transactions between patients and caregivers. Voters are presumed to understand and incorporate the law as it exists at the time they approve a measure, unless a measure explicitly incorporates future changes. *AB Cellular LA, LLC v. City of Los Angeles*, 150 Cal. App. 4th 747, 763 (2007); *Gonzalez v. City of Norwalk*, 17 Cal. App. 5th 1295, 1311 (2017). In 2016, voters knew that only non-profit cooperatives could sell medical marijuana. Thus, voters intended to exclude businesses that could have been medical marijuana consumer cooperatives as they existed in November 2016 and transactions between individual patients and caregivers where compensation does not exceed actual expenses. *See* San Diego Ordinances O-20793 and O-20795 (Feb. 22, 2017); Cal. Health & Safety Code § 11362.765. The effect of the voters’ intended exclusion was to exclude all medical marijuana transactions legally permissible at the time.

B. The City Can Add an Exclusion for Bona Fide Medical Marijuana Activities Conducted by for-Profit Operators.

The medical marijuana exclusion from the tax no longer has the effect of excluding all medical marijuana sales from the tax because of the post-Measure N changes to the Municipal Code and state law, creating a legal dilemma. Voters excluded nonprofit, medical marijuana-only businesses, but they also intended to limit the tax to non-medical cannabis. Nothing indicates that voters intended to allow the City to start taxing medical marijuana when it replaced nonprofit cooperatives with outlets in the Code. If there are no longer medical marijuana consumer cooperatives or their equivalent, all retail medical cannabis sales at City-permitted marijuana outlets would be taxable, which voters did not approve. *See AB Cellular*, 150 Cal. App. 4th at 163; Cal. Gov’t Code § 53750; *also see Gonzalez*, 17 Cal. App. 5th 1295 at 1311.

Measure N authorizes amendments to clarify any definition applicable to the tax. SDMC § 34.0132 (c). Thus, the Council can resolve this dilemma by adopting an ordinance amending the Municipal Code to allow for-profit operators to exclude some medical cannabis sales.⁶ To be consistent with Measure N, a clarifying amendment should achieve the same goals voters intended to achieve by excluding medical marijuana consumer cooperatives, like limiting compensation from excludable sales to actual costs and segregating excludable medical marijuana sales from taxable transactions. *See* SDMC § 34.0132 (c). A clarifying amendment could achieve this by limiting a for-profit marijuana outlet's compensation from excludable sales to actual costs and requiring customers to provide a Medical Marijuana Identification Card (MMIC) to distinguish bona fide medical marijuana sales from taxable transactions.⁷

Alternatively, the City Treasurer may be able to issue guidelines clarifying the medical cannabis exclusion to resolve the dilemma caused by the elimination of medical marijuana consumer cooperatives from the Municipal Code. SDMC § 34.0122.⁸ Regulations or guidelines must be "reasonably necessary to implement the purpose of the statutes," including resolving legal dilemmas caused by changes in related statutes. *Western States Petroleum Assn. v. Bd. of Equalization*, 57 Cal. 4th 401, 415 (2013); *AB Cellular*, 150 Cal. App. 4th at 763. Regulatory authority includes the ability to enforce less tax than may be due. *Id.* at 764. Once the voters establish a policy and have authorized regulations to administer that policy, administrative officials have the authority to determine "some fact or state of things upon which the law makes or intends to make its own action depend." *Id.* at 764 (citing *Kugler v. Yocum*, 69 Cal.2d 371, 376 (1968)).

The City Treasurer can decline to enforce the tax on certain transactions if it is reasonably necessary to achieve the voters' intended effect of excluding bona fide medical marijuana transactions from the tax. Here, the voters determined the policy of excluding bona fide medical marijuana transactions from the tax and the delegated authority to the City Treasurer to administer that policy. Like a Municipal Code amendment, guidelines should prohibit profit and require customers to provide their MMIC to be consistent with voters' intended effect of excluding verifiable, nonprofit medical marijuana sales.

⁶ As a policy matter, the City may want an exclusion for medicinal cannabis transactions at for-profit businesses to curb illegal cannabis activities. If all cannabis businesses become for-profit entities, all retail medicinal cannabis transactions in the City would be subject to the tax. This may discourage medicinal cannabis users from making purchases at properly licensed establishments collecting the tax and push those sales to unlicensed retailers purporting to be primary caregivers to avoid taxation.

⁷ Even though operators have been excluding sales to non-MMIC cardholders, adding an MMIC requirement is not a tax increase requiring voter approval. *See* Cal. Const. Art. XIII C. A tax must be approved by voters if there is: (1) a change in the mathematical equation used to calculate the tax resulting in taxpayers paying more; or (2) there are more taxpayers paying the tax. *AB Cellular*, 150 Cal. App. 4th at 763. There is no change in the math and there are no new taxpayers because operators are the taxpayers, not the customers. SDMC § 34.0104(a). Operators bear the burden of proving a transaction is excludable and the City Treasurer can require documentation if reasonably necessary to verify an excluded transaction. *See Dicon Fiberoptics, Inc. v. Franchise Tax Bd.*, 53 Cal. 4th 1227, 1235 (2012); SDMC §§ 34.0104(d) and 34.0124.

⁸ Although the City has no formal process for issuing regulations to administer tax laws, courts have considered similar language in taxing ordinances to provide authority for issuing less-formal guidelines to assist taxpayers. *Batt v. City & Cnty. of San Francisco*, 184 Cal. App. 4th 163, 169 (2010).

